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Citation for published version:

Scott, A, *An Independent Scotland Could Not be Required to Adopt the Euro as its Currency*, 2012, Web publication/site, Scottish Constitutional Futures Forum.
<<http://www.scottishconstitutionalfutures.org/OpinionandAnalysis/ViewBlogPost/tabid/1767/articleType/ArticleView/articleId/480/Drew-Scott-An-Independent-Scotland-Could-Not-be-Required-to-Adopt-the-Euro-as-its-Currency.aspx>>

Link:

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Document Version:

Publisher's PDF, also known as Version of record

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Drew Scott: An Independent Scotland Could Not be Required to Adopt the Euro as its Currency

Posted on November 09 2012

One of the key questions in the EU segment of the constitutional debate in Scotland is whether an independent Scotland could be required, under EU law, to adopt the Euro as its currency against the wishes of its government. To put the question differently – might the government of an independent Scotland that opts to retain sterling as the currency of the land find itself subject to an action for non-compliance with the Treaty provision that requires all member states (other than those with an opt-out) to adopt the euro as its currency?

The short answer is no. Even if we assume for the sake of argument that an independent Scotland would not inherit the UK opt out from the Eurozone, as matters stand EU law in this area simply cannot be used unilaterally to impose the euro on an unwilling non-Eurozone member state.

This can be demonstrated by a straightforward reading of the Treaty on the Functioning of the European Union (TFEU) along with a little understanding about economics! Both Article 140 (1) and Protocol 13 of the TFEU make clear that before a member state is *permitted* to join the Eurozone (i.e. adopt the euro as its currency) it *must* pass five specific economic tests (so-called convergence criteria set out in the 1993 Maastricht Treaty). These tests are (i) compliance with the deficit-to-GDP (3%) and (ii) debt-to-GDP (60%) ratios; (iii) recording an inflation rate within 1.5 percentage points of the three best performing Eurozone countries; (iv) having its long term interest rate (defined as yield on 10-year government bonds) within 2 percentage points of the three best performing Eurozone countries; (v) having its currency pegged against the euro inside the EU Exchange Rate Mechanism (ERM) for 2 years without “serious disturbance” (i.e. without realignment).

Unless all five criteria are satisfied then, under the Treaty, a country is not allowed to adopt the euro as its currency. And there are no provisions for exceptions to this rule in the Treaty. The question then is whether or not the European Commission can require, under law, a non-Eurozone member state to comply with the five convergence criteria? As matters stand it cannot.

Take the requirement that the currency has to be inside the ERM for a minimum of 2 years prior to adopting the euro. In two Council Decisions (dating from 1997 and 2006) on the functioning of the ERM the member states state that:

“...participation in the exchange rate mechanism will be voluntary for the Member States outside the euro area. Nevertheless, Member States with a derogation can be expected to join the mechanism. A Member State which does not participate from the outset in the exchange rate mechanism may participate at a later date.” (ERM Resolution, 2006)

The position is very clear – new member states are *expected* to participate in the ERM, but they are not legally bound to do so. Nor is ERM participation required (or expected) within any particular time limit.

This position was also reflected in a European Central Bank publication ahead of the 2004 EU enlargement:

“...the choice of the monetary and exchange rate strategy after EU accession is, in the first instance, a responsibility and prerogative of the Member State concerned.

The ten new Member States will all join the European Union as Member States with a derogation. This means that, while not yet adopting the euro, they will be committed to striving towards the eventual adoption of the euro upon fulfillment of the convergence criteria laid down in the Treaty. The Treaty foresees that: i) at some point following accession, new Member States will join the Exchange Rate Mechanism II (ERM II); and, ii) when they are deemed to have fulfilled the Maastricht convergence criteria, they will adopt the euro.” (*Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries*, December 2003)

Again the formal position is quite clear. Joining the ERM and thereby eventually fulfilling that precondition for adopting the euro is a matter for the member state alone. There is simply no basis under EU law whereby a new member state can be required to participate in the ERM – in the absence of which it cannot join the Eurozone.

From an economic perspective this is unsurprising. Requiring the currency of a new member state to join the ERM at a specific parity against the euro immediately on EU entry makes no economic sense. No EU policy-maker would propose this. None ever has.

Therefore leaving to one side the question of Scotland inheriting the UK Eurozone opt-out, it is clear that unless the government of an independent Scotland (i) voluntarily gives up sterling as the currency of the country and introduces a new Scottish currency, (ii) voluntarily opts to peg this new currency inside the ERM and (iii) voluntarily retains this initial peg against the euro for 2 years, it will not be *permitted* (far less obliged) to join the Eurozone.

But it is not only the voluntary nature of membership of the ERM that undermines assertions that an independent Scotland could be forced as a matter of EU law (and against its wishes) to comply with the pre-conditions set out to join the Eurozone.

Consider the Eurozone entry test that stipulates the long-term rate of interest (defined as yields on 10-year Government bonds) in the non-Eurozone country *must* be within 2 percentage points of the average of the three Eurozone members with the lowest rates. This is an obligation that *no* government possibly can deliver, or indeed could conceivably be asked to deliver far less legally bound to do so. The yield on a government bond is determined by the discount on its “face (coupon) value” that investors demand to hold the bond in exchange for lending funds to the issuing government. Amortizing this discount over the lifetime of the bond equates to the (long-term) annual rate of interest the borrowing government pays to the lender, and this is the rate to which the convergence test applies. However that discount – which determines the market price of the bond and so the long-term interest rate – is set entirely by traders in the international capital market and reflects what buyers are prepared to pay for a bond. This in turn will depend on the perceived risks of investing in the bond of a particular government – risk being determined by a host of economic and political factors unique to the country concerned, although certainly including the likelihood the government will not be able to redeem the bond at its face value when required (i.e. will default). The assessment of country

risk is a service undertaken by independent credit ratings agencies (e.g. Moodys, Standard and Poor's) who attach a specific **grade to bonds** presented for sale by every government in the world.

Self-evidently it is entirely outside the control of any government to determine the discount (and so market price) at which its **long-term debt** instruments trade in international capital markets. Therefore it is simply *not possible* for a government to deliver a long-term interest rate close to the average of the three "best performing" Eurozone countries in this respect. To suggest otherwise is economic illiteracy.

Therefore the argument is not only that EU law does not as a matter of fact provide a mechanism obliging a member state to meet the economic conditions necessary to be eligible to join the Eurozone, but that it is quite impossible that EU law ever *could* be used in such a manner.

Finally it is worth recording that immediately on joining the EU a country *automatically* will be deemed to have a derogation from the obligation to adopt the euro. The derogation is automatic simply because as a new member state the country could not possibly have been inside the ERM previously, and so cannot meet the requirement of 2 years ERM participation before being allowed to adopt the euro. However, as noted earlier, the new member state need *never* opt to join the ERM and so will never find itself being in the position of being legally eligible to adopt the euro, far less being required to do so. This is the path that Sweden has followed, unmolested, since joining the EU in 1995.

It is vital that the debate on independence is as informed as possible. Those who insist that an independent Scotland in the EU could (or would) find itself in the situation of being required as a matter of EU law to join the Eurozone are simply wrong for the reasons set out above. This conclusion is not based on a particular "interpretation" of EU rules governing the Eurozone: it is based simply on reciting these rules.

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